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Social Models, Growth and the International Monetary System: Implications for Europe and the United States

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Social models, growth and the international monetary system: Implications for Europe and the US

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Abstract:

This paper explores the relationship between economic growth and the welfare state. We argue that: (i) the institutional constraints set by the international monetary system may be at least as effective determinants of growth differentials between countries as the different dimensions of their welfare states. We show how this international system may impose an asymmetric discipline/flexibility mix on the macreoconomic policies of different countries, thereby influencing their growth performance.; (ii) the European currency reshapes some of the pre-existing constraints and also open up new opportunities; (iii) in the new international setting, Europe is facing a choice between alternative models. In one alternative, the "welfare system" needs to be reduced to a minimum; in the second, its role should be enhanced and made more active, through an appropriate mix of welfare policies oriented towards the promotion of social well-being and policies oriented towards the promotion of productive capacities.

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"All these objectives are inextricably linked: the large market, technological cooperation, strengthening the European monetary system, economic and social cohesion and the social aspects of collective action" (Jacques Delors)[3]

1.Introduction.

Is there a trade-off between social protection and economic growth?

Few days after the French referendum on the EU Constitution, *The Economist*, (june 4th-10th "It is Chirac, stupid", p.12) proposed its own interpretation of the results: "Leaders can respond to such discontent in two ways. One is to pretend that the French social model is still valid, that no trade-off exists between social protection and economic growth, that France can close the shutters and shelter from global capitalism, that all the blame belongs to with outside forces – whether globalization, America or Brussels. The other is to admit that France cannot isolate itself from the world economy, to explain that the new markets are an opportunity for French companies, that job losses in manufacturing can be balanced by jobs creation in services and that inflexible social protection deters the creation of new jobs". This popular approach proposes the "American social model" as the successful alternative to the so-called "French social model".

But Tony Atkinson (1999), reviewing ten cross-country studies, reported that four of these studies found a positive association between social security expenditures and growth rates, four found a negative coefficient on the transfer variable, and two found that the coefficient was insignificant. Atkinson concluded his thorough analysis by arguing that empirical evidence on the issue is inconclusive. Moreover, different predictions derive from alternative theoretical models.

Thus, economic analysis does not seem to provide unconditional support to the columnist's strong beliefs concerning a trade-off between growth and the welfare state. Consequently, it seems appropriate to enquire whether other factors, different from "social models", should be brought into the picture to explain growth differentials among different countries.

One factor which is certainly relevant in this context are the macroeconomic policies which different countries have been implementing in the recent years. These policies influence these countries' economic performance, by imposing a different "discipline/flexibility mix" upon each of them. And -most importantly- these policies are, to some extent, themselves dictated by some underlying economic constraints which "bite" differently on different economies. Thus, the variable "discipline/flexibility mix" experienced by different countries may find its ultimate roots in these underlying factors.

[3] Jacques Delores, 9th Jean Monet Lecture at the European University Institute, Florence (as quoted in Bertola, Jimeno, Marimon, and Pissarides, 2001, p.23).

This paper argues that prominent among these constraints are those rooted in the international monetary system, and in the roles played by different countries within it. In section 2 we propose an analysis of how this institutional setting may influence growth differentials between Europe and the United States[4]. It is surprising that, for all the emphasis recently put on institutional arrangements as determinants of economic performance, such pervasive institutional constraints should be generally ignored in current discussion of the "endogenous virtues" of alternative economic systems, and of their relative growth proclivities, while the institutions of the welfare state should be left as the main "institutional culprit". We argue that the institutional constraints set by the international monetary system may be at least as effective determinants of growth differentials between countries as the different dimensions of their welfare states.

Having made the first point, we start from the fact that a group of countries (in our case, twelve European countries) have been able, through monetary unification to re-shape –though certainly not abolish- the constraints binding their policy options. On this basis, we raise our basic questions concerning the relationship between welfare and growth: is economic growth compatible with one single social model, or with a variety of welfare systems? Should Europe give up its welfare oriented social system, as *The Economist* suggested in the article quoted above, or rather rediscover and implement a model centred on citizens' welfare? We argue that, even within the international constraints, Europe is facing a choice between alternative models. In one alternative, the "welfare system" needs to be reduced to a minimum while, in the second, its role should be enhanced and made more active. The choice will depend on the preferred definitions and measures of growth, wealth and welfare.

2. Flexibility and discipline in the international monetary system.

2.1. Current accounts surpluses and deficits.

We have argued in the introduction that the international monetary system may discipline countries' macroeconomic policies to different degrees. This section clarifies the point through a simplified analysis of how this asymmetric discipline/flexibility mechanism may work in practice, and affect the potential for economic growth in different countries.

To keep things simple, we start with a world inhabited by only two open economies: country A issues the international currency, which we call the USD, while country B issues its own currency.

From the function of international means of payments assigned to USD, and from the non-

[4] We take for granted that supply side factors exert a powerful influence on growth; nevertheless, in this paper we focus on the international monetary system, in order to enquire whether it may exert an independent influence on growth differentials.

synchronisation of international sales and purchases, it follows that (just as an individual agent keeps a reserve of "liquid" assets), country B needs to accumulate a reserve of USD (Graziani, 1979). How is country B going to "buy" the reserves it needs?

The only thing B can give in exchange is the goods that it produces, since its own currency- not being a means of international payments- is worthless for country A. In addition to selling goods to A, in an intertemporal perspective country B may try and sell claims to its future income, by convincing international investors to make direct and indirect investment in B. Abstracting from this and other types of international transfers, national accounting identities imply that the value of country B's purchases of USD is identically equal to the value of its sales of goods and services to country A. In other words, country B's trade surplus matches its capital account deficit (recently re-labelled its financial account) i.e. its purchases of international reserves. The equality holds, with opposite signs, for country A's balance of payments[5].

If country B is growing and, consequently, is involved in an increasing volume of international transactions, its demand for reserves grows over time. Thus, country B runs into systematic current account (trade) surpluses, and correspondingly country A runs into systematic trade deficits[6]. The international monetary system has a built-in mechanism whereby goods are transferred from country B to the country issuing the international means of payments (though this tendency might be offset by counteracting flows on either side of the balance of payments).

The fundamental national accounting equation for open economies tells us that, for both countries:

$Y - E = X - M$

where Y is income, E is home expenditure, X is export and M imports.

The only difference between them is that the sign on both sides is positive for country B, negative for A. In other words, country A's expenditure exceeds its production[7].

[5] Country A can finance imports of goods and services (in excess of its exports) only by borrowing from country B, i.e. by selling assets to B. Selling asset to foreigners is registered as a + in the financial account of the balance of payments. Thus, a current account deficit is always matched by an equal financial account surplus. Since selling assets implies borrowing from abroad, a trade deficit and a corresponding financial surplus amounts to an addition to country A's external debit.

[6] Oppenheimer (1982, p.192) defined "normal or equilibrium" surpluses those which occur "in an expanding world economy where monetary authorities will tend to be more tolerant of persistent small surpluses than of equivalent deficits".These surpluses will entail "deficits elsewhere in the system" , elsewhere being county A in our discussion.

[7] A given excess of domestic expenditures over national income is compatible with different combinations of consumption, investment and public expenditure. Thus, external deficits are not necessarily "determined" by expansionary fiscal policies, as the "twin deficits" hypothesis implies. With reference to the current US external deficit, for instance, it has been noticed that: "from the mid 1990s until the end of 1999 the US current account deficit was largely a reflection of exceptionally high levels of investment Starting in 2000, but especially in 2001, investment collapsed. Private saving also collapsed, so there was no net improvement in the current account prior to the recent

Call this Asymmetry 1.

Country A buys the excess of externally produced goods by issuing USDs. As the world economy grows, it is a good thing for both countries if the international means of payment grow correspondingly, thus avoiding liquidity constraints on international transactions.
Country A may be viewed as the provider of either "the public good of international money, or, the private good for itself of seignorage, which is the profit that comes to the signeur, or sovereign power, from the issuance of money" (Kindleberger 1981, p. 248). Under either interpretation, A's reliance on continued demand for USDs as reserves makes expansive monetary policies relatively easy (see also below, p. 6). Country B may benefit or loose as a result, but is not in a position to make an independent monetary policy as far as the international currency is concerned (remember that country B is the sum of many uncoordinated small countries).
Call this Asymmetry 2.

Given its structural current account deficit, country A may be at a risk of paying its arguably high propensity to import (or, in a long run perspective, a high income elasticity of imports) with a downward pressure on domestic production, since a high proportion of its income buys foreign rather than home-produced goods. But this risk can be reduced if other components of aggregate demand are high enough to pull home production up to compensate for the import-determined downward push. If private expenditures fail to do so, public expenditure is a good candidate, to the extent that it stimulates domestic production. Thus, there is a built-in mechanism making expansionary fiscal policy "desirable" in A.
By contrast, country B should adopt more severe fiscal policies, as expansionary fiscal policies may crowd out exports directly or via their impact on domestic consumption, thus impairing its ability to sustain the required external surplus.
Call this Asymmetry 3.

Does country A leave beyond its means? Yes and no: yes, because every year its buys and uses up more goods than it produces (i.e. its national saving is negative), meaning that foreign citizens, institutions and governments have been financing the excess spending through a fund inflow to the country. No, because it finances this excess by selling assets, i.e. claims to its future income. In

swelling of fiscal deficits" (Obstfeld and Regoff, 2004, p.6-7). On the other hand, it is certainly true that, starting from a balanced current account, an expansionary fiscal policy generates a current account deficit, if an *ad hoc* hypothesis of offsetting changes in consumption and investment is avoided (such as the hypothesis that consumers are Barro-Ricardians).

other words, A may be living beyond its current means, but only as any debtor does, i.e. by exchanging current consumption (by importing goods) for future consumption (when it pays off the loan). Thus, in order to give a more precise answer, we need to enquire further into the nature of these assets.

2.2. The balance of payment: trade relations and financial flows.

Let us starts with some commonplace statements.

Country A's CAD must be equal to its financial account surplus. Because A is a net importer of commodities, capital must flow into A from country B.

As its output and exports expand, country B needs to accumulate reserves (this may be determined by a fixed output/reserve or import/reserve accumulation objective). Thus, because B's demand of USD is always increasing in an expanding world economy, reserve accumulation by country B (and, more generally, its demand for A's assets) is reflected into A's growing external deficit (to the extent that this flow is not offset by A's external investment into B)[8].

It may be considered as a paradox that country B is lending to A, and not vice versa: in current discussion of US external position this point has been made by Roubini (2005); Triffin (1984) and Lucas (1990) had similar worries. Roubini argues: "US deficit is "unprecedented" in the sense that the while the US is the largest country in the world, it is also the largest net debtor and the largest net borrower ever. Superpowers tend to be net creditors and net lenders". It is certainly a paradox that emerging countries lend to the US and not the other way around. But, to some extent, this systematic borrower/debtor position is conferred on A by the very "special international status of the US dollar" (to borrow Bernanke's expression, see below, fn. 13): this happens because country B's reserves need to be kept in the international currency, and because it does not pay country B's Central Bank to keep them idle and barren in their vaults.

The "essence of the regime" was described fifty years ago by Jacques Rueff in a very interesting discussion with Fred Hirsch. His analysis retains some interest in spite of the many changes undergone by the monetary system, and perhaps even more *because* of these changes. Therefore, it

[8] To-day, the link between the external deficit of the "leader" and that of developing countries, and the dimensions of these imbalances is at the center of the current debate. Bernanke (2005) observed that the bulk of the increase in the U.S. current account deficit was balanced by changes in the current account positions of developing countries between 1996 and 2003. Obstfeld and Rogoff (2004) also noticed that dollar denominated reserves are held mostly by developing countries in Asia, followed by Russia, Mexico and Brasil. "Indeed, during late 2003 and 2004 foreign central bank acquisition nearly equalled the entire US current account deficit".

is worth quoting it at length:

> " What is the essence of the regime, and what is its difference from the gold standard? It is that when a country with a key currency has a deficit in its balance of payments – that is to say, the United States, for example- it pays the creditor country dollars, which end up in its central bank. But the dollars are of no use in Bonn, or in Tokyo, or in Paris. The very same day, they are re-lent to the New York money market, so that they return to the place of origin. Thus the debtor country does not loose what the creditor country has gained. So the key-currency country never feels the effect of a deficit in its balance of payments. And the main consequences is that there is no reason whatever for the deficit to disappear, because it does not appear.
>
> Let me be more positive: if I had an agreement with my tailor that whatever money I pay him he returns to me the very same day as a loan, I would have no objection at all to ordering more suits from him" (Rueff and Hirsch, 1965, p. 3)[9].

As Rueff confirmed in this passage, capital inflows to country A are determined by the very nature of the international monetary system. But then the next question is: do capital inflows need to be attracted by relatively high real rates of return? "Conventional wisdom" held that this should be the case[10]. But there is evidence that the correlation between (long run) interest rates and net foreign liabilities of industrialised countries (country A in our model) has been relatively weak for more than a decade (IMF, 2005, p.117). How could this further paradox be explained?

At least in part, the answer may be found in the behaviour of country B's Central Bank, and on the

[9] It is interesting that Kant condemned this feature of the gold-exchange standard, and also pointed out one of its particularly unpleasant consequences as early as 1795: "….a credit system under which debts go increasing indefinitely… is a dangerous money power. This arrangement -the ingenious invention of a commercial people in this century- constitutes in fact a treasure for war, exceeding the treasures of all other States taken together. It can only be exhausted by the ensuing deficit of the exchequer, which may be long posponed by trade prosperity and its impact upon production and profits.

This facility for waging war, combined with the inclination of rulers towards it (an inclination that seems implanted in human nature) is therefore a great obstacle to perpetual peace. Its prohibition must be made a preliminary article of it, all the more so as the inevitable bankruptcy would encompass many other states in the eventual ruin, without any fault on their part". (E.Kant, *Perpetual Peace. A Philosophical essay*, as quoted in Triffin, 1984).

[10] International investors would only demand country A's assets in the presence of a positive differential between r_A and r_B, i.e. between the two countries' real interest rates. Given the link between interest rates and exchange rates, this view also implies that country A's CAD should be accompanied, and therefore determined, by an appreciation of the USD relative to the other country's currency (Krugman, 1999, p.xiii, pp. 5-6). This line of thought also implies that a depreciating USD would sooner or later (as the economy moves up on the rising arm of the J-curve) restore current account equilibrium. However, the current account deficit in country A, and the corresponding capital inflow, have been sustained since the beginning of the Eighties, both with an appreciating and a depreciating USD.

influence this behaviour may have on private investors. As we have seen, B's Central Bank "institutionally" needs to keep reserves USD denominated assets. Moreover, and most importantly, country B, as an emerging country, has strong incentives to accumulate reserves in order to avoid an appreciation of the national currency (USD depreciation), in order to sustain the competitiveness of its exports. Furthermore, the Central Bank's precautionary demand may rise in periods of turbulence in financial markets, as it buys reserves as an insurance device against speculative attacks. Because B buys financial inflows by selling enforceable claims to its future wealth, the risk of default on its external debt imposes great financial prudence on B[11]. A high precautionary demand may be the result of having learned the lesson of financial crises, rather than a pure market phenomenon.

B's private investors will be encouraged to buy country A's assets by their Central Bank support for the external value of the USD (Roubini and Setser, 2004). It is probably partly as a consequence of all these motivations that "globalization" has weakened the responsiveness of capital flows to interest rates differentials, by reducing "home bias" in asset holdings [12]. This weakened relationship between capital flows and interest rates may be explained by massive capital inflows from country B exerting a downward pressure on A's interest rates. Country B is in a less fortunate position: country A's Central Bank has no incentive to buy B's currency.

Summing up, the "international status of the dollar" (to use Bernanke's words again)[13] is at the root of the paradox whereby domestic savings in B are diverted from domestic investment, and

[11] See the high ratio of reserves to imports of goods and services in China, India and Russia (IMF, 2005, p.260, tab. 35).

[12] Home bias is the tendency for private investors to "place the bulk of their financial wealth in domestic assets despite more favourable risk-return profiles –before transaction costs and taxes- of globally diversified portfolios" (IMF, 2005, pp.111-112). Home bias is incorporated in a recent model by Blanchard, Giavazzi, Sa, 2004).

[13] Bernanke, 2005 describes this phenomenon by focusing on the "special international status of the U.S. dollar: "The attractiveness of the United States as an investment destination during the technology boom of the 1990s and the depth and sophistication of the country's financial markets (which, among other things, have allowed households easy access to housing wealth) have certainly been important. *Another factor is the special international status of the U.S. dollar. Because the dollar is the leading international reserve currency, and because some emerging-market countries use the dollar as a reference point when managing the values of their own currencies, the saving flowing out of the developing world has been directed relatively more into dollar-denominated assets, such as U.S. Treasury securities. The effects of the saving outflow may thus have been felt disproportionately on U.S. interest rates and the dollar. For example, the dollar probably strengthened more in the latter 1990s than it would have if it had not been the principal reserve currency, enhancing the effect on the U.S. current account"* (our italics).

channelled towards country A[14].

Call this Asymmetry 4.

2.3. *External adjustment.*

Barring "Ponzi finance" (a scheme in which new loans are used to pay interest on old debt) in the long-run debts must be paid back. Thus, we bump into the long-run consequences of the debt-credit relations in the international monetary system. As we will see, the difference between "Bretton-Woods" and the post Bretton-Woods regime is relevant here.

If a country is a systematic borrower its debt towards country B will cumulate over the years, as the growth in payments to factor service income to foreign investors accompanies the increasing holdings of assets by foreigners. Growth in these payments worsens both the country's current account deficit and its net debt position, thus leading the country into a "debt trap". The U.S. has been a net debtor country since the beginning of the Eighties.

A country's external debt is sustainable, according to standard definitions, if the debt/GDP ratio is constant at some target level (IMF, 2005, p. 144). Otherwise, your debt will "explode", unless… unless you are country A. In this case, capital gains from exchange rate adjustment may add a degree of flexibility.

Why does country A benefit from a depreciation in its currency? As is well known, depreciation is necessary in order to restore current account equilibrium in country A. But depreciation also has the very convenient effect of improving its net foreign position (thus also reducing the needed amount of trade adjustment) (Gourinchas and Rey, 2005; IMF, 2005, p.126).

This happens because a depreciation of the USD increases the value of country A's holdings of foreign assets. Thus the country's net debt position improves (Lane and Milesi-Ferretti, 2001, 2004; Tille, 2003; Obstfeld 2004; IMF, 2005). This valuation effect amounts to a net wealth transfer from the "rest of the world" to country A.

There is another side to the valuation effect: creditors bought dollar-denominated assets *before* the depreciation of the dollar, thus incurring a loss which is obscured, but not eliminated, by the fact that the value of a dollar is still a dollar after depreciation (and, consequently, the nominal value of U.S. liabilities is unchanged). This loss would be made more visible by reckoning the

[14] Bernanke (2005): *" Effectively, governments have acted as financial intermediaries, channelling domestic saving away from local uses and into international capital markets. A related strategy has focused on reducing the burden of external debt by attempting to pay down those obligations, with the funds coming from a combination of reduced fiscal deficits and increased domestic debt issuance.* Of necessity, this strategy also pushed emerging-market economies toward current account surpluses. Again, the shifts in current accounts in East Asia and Latin America are evident in the data (…) (our italics).

loan, for instance, in terms of the amount of the traded goods that foreign countries had originally to give up for each dollar, and similarly reckoning the new value of the US debt after depreciation. In some sense, this side of the valuation effect amounts to a "debasement" of the unit of account in which the debt is denominated.[15]

The "valuation effect" can play a substantial role in international adjustment. According to recent empirical estimates this financial channel has historically (i.e. from the Seventies onwards) contributed to 30% of the US financial adjustment, as has been shown by Gourinchas and Rey (2005). These authors also show that exchange rate adjustments are predictable, and, therefore, should not be modelled as surprise events. This result raises the question why should rational investors be willing to finance US current account deficits and hold US assets "knowing that these assets would underperform" (one possible explanation, as we have seen, focuses on the choices of country B's Central Bank).

Is country B in a position to resist the appreciation of its own currency relative to the USD? Only to the extent that it is willing (and allowed) to buy virtually unlimited amounts of dollars at the going price, thus exerting a stabilising influence on the exchange rate, i.e. "pegging" to the dollar.

This is exactly what European countries did, until the "Bretton- Wood 1" system collapsed. This is also what the Central Banks of Japan and China have been doing for many years under "Bretton-Woods 2", although they started to give in to western pressures in July 2005 (for the distinction between Bretton-Woods 1 and 2 see Dooley, Folkerts-Landau and Garber, 2003).

Why is the distinction between "Bretton-Woods" and the current regime relevant? In "Bretton-Woods", the USD had an "anchor", gold. This anchor did impose some degree of discipline on country A's external imbalances, although it may be disputed how much this constraint was biting in reality[16]. Faced with these imbalances, owners of dollar-denominated reserves may have asked to convert them into gold, and, because country A had to sell the required amount at the

[15] Neapolitan monetary economists in the XVII and XVIII century used to call this the "alzamento" (the "rising") and argued that, through the alzamento (the rise in the price level) sovereigns enacted a debasement of money, i.e. a misalignment between the value of money and the value of its metallic base. On this and other distributional effects of money injections see Costabile (2004) and (2005).

[16] Oppenheimer (1982, p.193), for instance, argued that "because of the exceptional strength and confidence enjoyed by the dollar at the beginning, and policy moves later by the United States to prevent conversions of dollars into gold, the imbalance of the system was able to continue for a considerable number of years –so much so that the imbalance came to be wrongly seen as a trademark of the system itself".

fixed rate of 35 USD per ounce of gold, it might have faced a severe drain in its gold reserves. Such a "gold rush" (or, more technically, a run on the U.S. gold reserves, i.e. a massive conversion of dollar reserves into gold) was, for many years, only a virtual possibility. Nevertheless, De Gaulle at some stage tried to convert France's dollar reserves into gold, on the grounds that the international exchange needed "an unquestionable monetary basis which does not bear the mark of any individual country" (De Gaulle 1965, quoted in Rueff and Hirsch, 1965)[17].

In the post Bretton-Woods system, the international currency is not anchored to gold, or to any other base. With inconvertibility, a pure debt-credit relationship among countries is established (Quadrio Curzio, 1982, p.12). This makes the discipline even weaker on country A, which may become more willing to run into sustained external imbalances because, faced with a heavy net external position, it may more easily resort to depreciation as an instrument for external adjustment.

By contrast, a depreciation of B's currency implies an increasing burden of its external debt. The underlying reason is that Country A's debt is denominated in its own currency, while country B's debt is typically denominated in country A's currency[18].

Call this Asymmetry 5.

2.4. Macroeconomic policies and growth in an asymmetric world.

Let us look at the consequences for growth of the five asymmetries indicated above. Firstly, macroeconomic policies have a different role to play in A and B. Thanks to the international status of the USD, plus other related, facilitating circumstances (which are gaining momentum with globalization), country A enjoys a certain flexibility concerning its monetary policy, and both its external and public deficits.

(i) A's reliance on continued demand for USDs as reserves makes expansive monetary policies relatively easy because, as Rueff explained, whatever amount of money is created, it comes back straight away to A's Central Bank.

(ii) Capital inflows buy the country's financial liabilities, and may help finance country A's

[17] The United States responded by "making clear that requests to convert dollars into gold at the Federal Reserve Bank of New York, though legally possible, would be viewed as an unfriendly act" (Dam, 1982, p.187). By this move, as the Italian Central Banker Guido Carli later observed "the fiction of dollar convertibility" had been "stretched beyond the limits of credibility" (Carli, 1978, p.409). The Bank of England tried to convert its dollar reserves on the 12th-13th of August 1971, and that was the end of "Bretton-Woods".

[18] On other consequences of the currency denomination of foreign debt see the literature on the "original sin" (e.g. Eichengreen, Hausmann and Panizza, 2005).

investment, consumption, or public deficits, in the latter case allowing the country to adopt a relatively relaxed fiscal stance.

Thanks to these macroeconomic policies country A experiences a model of growth led by domestic demand. Symmetrically, country B' growth is export-led.

Obviously, supply side considerations are relevant to both economies. For instance, country A may combine expansive macroeconomic policies with "supply side" measures, which have strong distributional consequences. Similarly, in country B, supply side reforms may prevent wages from rising in line with productivity growth, thus encouraging profits and, possibly, exports.

The relationship which binds the two countries together is rooted in the very nature of the monetary system: in a monetary economy country B needs A's money, and hence A's demand for goods "made in B", in order to stimulate its growth. A, in turn, becomes dependent on the goods made in B for satisfying the needs of its population.

Because country A specialises as the locomotive of the world economy, the rest of the world needs the expansion of A's demand for foreign goods, and –in return- is willing, or compelled, to accept A's liabilities. When the net financial position of country A becomes risky or unsustainable, external adjustment is restored through exchange rate adjustments, which, as we have seen, are helpful on both sides of the balance of payments…. And the process is ready to start again.

2.5. New constraints and opportunities for Europe.

What is the role of Europe ?

In the Bretton-Woods era, Europe played as a B country, a role which the Asian Tigers, Cina, India, subsequently inherited, and will probably pass to other countries in the future (Dooley, Folkerts-Landau, Garber, 2003). To-day Europe is playing a new role, which is partly the result of spontaneous evolution within the international monetary system, but, as we will see below, is partly the result of an independent project, aimed at liftingsome of the constraints set by the system itself.

The world economy becomes less simple than our two-country model with the emergence of this third "country" (let us call it *E type*), and its new currency, the Euro (we leave other groups of countries, such as Africa, out of our picture).

Real world developments –if analysed in this three-country framework- may provide an answer to our first question. Growth differentials between Europe and the US may- to a substantial extent- depend on the different roles played by countries within the international system, for at least two reasons.

Firstly, while Europe is a developed economy, the Euro does not share the privileged position of being the international reserve currency (yet?). Consequently, almost by default, it cannot rely on the five symmetries referred to above. Secondly- the required credibility of the new currency could not be established without additional constraints on the joining countries' macroeconomic policies. These further constraints were unavoidable in the absence of fiscal unification, which Europe was unable to achieve[19]. Therefore, European macroeconomic policies are constrained by the need to strike a difficult balance between "credibility" and "growth steroids" (the latter being a label used for expansive monetary and fiscal policies by Eric Chaney of Morgan Stanley, who synthesised this point well: "Europe did not use growth steroids").

We argue that such pervasive institutional constraints as those inherent in the international monetary system should be included in the current discussion of the "endogenous virtues" of alternative economic systems, and of their relative growth proclivities. Their neglect in current discourse may be unwarranted, and explain why the institutions of the welfare state are considered as the main "institutional culprit".

Having made this first point, we think that the relationship between the welfare state and the economic performance of nations requires to be reassessed in the light of the new choices that Europe is facing in the present.

Europe has not merely adapted to the evolution of the international economic framework; it also has undertaken autonomous steps in order to change its position within it. Though the system of international payments constrains economic policies, it still leaves room for independent -if constrained- choices, which countries may make in order to shape, or change, their position within it.

The Euro is one example of such independent choices. A strong, credible common European currency is seen by European countries as a means to introduce more choice and competition within the international monetary system, to protect European interest within it and, by so doing, to act as a lever for better political integration among the member countries.

[19] The new currency required a severe policy stance, both on the monetary and the fiscal side. "Convergence" criteria were needed to make the Euro "credible" at its birth in international markets, and to keep it in good health afterwards. This objective would require, first of all, that the joining countries adopt sound monetary policies as a means to achieve convergence and to keep up the external value of the new money. Secondly, it required that the joining countries should also make a commitment, so to speak, not to undo with their fiscal policies what they were building via monetary policy. Relaxed fiscal policies may lead to free rider problems among European countries, generate a pressure on the European Central Bank to monetize current deficits, or, in the longer run, may call for unexpected inflation as a means to cut the real value of high public debts.

A further, less obvious logic implication of the European project is that, gradually, as Europe becomes able to offer an additional, credible reserve currency to the international economy, it also becomes less dependent on *systematic* current account surpluses. If seen from this point of view, the European project is both an economic and a political project. In this framework, well devised welfare policies, together with incomes policies linking wages to productivity growth, may be instrumental to achieve higher domestic demand and (as we will see below) a stronger competitive hedge.

For these reason, the new currency area and the underlying political process reshape some of the pre-existing constraints[20] and also open up new opportunities. Europe is devising a process of economic and political integration which has no historical antecedents. Within the constraints that we have (partially) illustrated thus far, this gives her the opportunity to stop and consider the alternative routes to a strong economic performance and – at the same time- a desirable system of welfare for its citizens. The remaining part of this paper is devoted to a tentative exploration of these alternative routes.

3. Wealth and Welfare Revisited

In the opening passage of the *Wealth of Nations*, Adam Smith forcefully points out that there is an important relationship between the wealth of a nation and the welfare of its citizens:

> The annual labour of every nation is the fund which originally supplies it with all the necessaries and conveniences of life which it annually consumes, and which consist always either in the immediate produce of that labour, or in what is purchased with that produce from other nations (Smith, *WN*, Introduction and Plan of the Work).

The above passage calls attention to the relationship between the 'wealth' of a nation (ultimately, its labour fund) and the availability of goods and services necessary to human life. Smith's definition of wealth is in no way limited to the supply of marketed goods and services[21]. As pointed out by

[20] Europe is now in a position to face a larger spectrum of monetary policy choices, although, the Euro not being a magic wound, these are difficult choices. For instance, in these years Europe is facing the following dilemma: it may either join China and Japan in accumulating reserves in dollars, or refuse to do so. The former alternative would help stabilise the dollar, by sustaining its external value, thus preventing further appreciation of the Euro, which is harmful to Europe's competitiveness. But, by so doing, Europe would help financing us deficits, and the US international policy financed thereby. The alternative is that Europe refuses to accumulate huge reserves in USD denominated assets: but this amounts to contributing to further USD depreciation that may harm European competitiveness, particularly because of slowly adjusting USD-renmibi exchange rate.

[21] From Smith's point of view, the wealth of nations includes 'social common capital', as recently defined by Hirofumi

Giorgio Fua', the most distinctive feature of Smith's definition of national wealth is the fact that 'the notion is established by considering an object […] which is a collection of things […] defined from a dual point of view: their attitude to satisfy the needs or at least the tastes of life; the way in which they are obtained, that is through the carrying out of human labour' (Fua', 1957, p. 21).

Smith's conception does not entail any presumption that the wealth of a nation should be measured primarily by the quantity of traded commodities available to that nation directly or through international trade. Smith's criticism of the mercantilist association between the wealth of a nation and its *treasure* (its current account surplus) suggests that, in his view, treasure is not a secure basis for the increase of national wealth.

Indeed, Smith argues that, under certain conditions, a persistent current account surplus could be associated with the gradual contraction of national wealth. This would be the case if a nation were to expand its treasure (its current account surplus) by becoming less and less able to meet the needs of its citizens.

Smith points out that production and division of labour are the primary means by which it is possible to increase wealth *as welfare*. However, the characteristic of labour activity that is here in the foreground is the provision of human needs, *not* the provision of goods through markets.

Smith's wealth comparisons are based on the measurement of wealth as *labour commanded*. This is the quantity of 'external' labour (labour of other individuals, or of other countries) that any given individual (or country) has at her disposal through the sale of her assets (material goods, financial activities, or even working activity itself).

Uzawa (Uzawa, 2005). According to Uzawa, 'social common capital provides members of a society with those services and institutional arrangements that are crucial in maintaining human and cultural life. It is generally classified in three categories: natural capital, social infrastructure, and institutional capital' (Uzawa, 2005, p. vii). Arthur Cecil Pigou, following a suggestion of Marshall, stressed the relationship of wealth to welfare, but narrowed the definition of *economic* welfare to 'welfare arising in connection with the earning and spending of the national dividend, or, in other words, of those parts of the community's net income that enter easily into relation with the measuring rod of money' (Pigou, 1912, p. 3). Partha Dasgupta and Karl Göran Mäler have emphasized the need to detach cross-country comparisons of social welfare from comparisons in terms of gross domestic product (GNP) or net national product (NNP): 'social well-being in a country is higher (lower) than in any of its immediate neighbours if the value of the difference in the flow of consumption services between them plus the difference in the value of aggregate net investment between them is positive (negative)' (Dasgupta and Göran Mäler, 2000, p. 86). This proposition leads to the conclusion that 'social welfare is higher today than it was yesterday if the economy is wealthier today', so that 'cross-country comparisons of NNP [or of GNP] tell us nothing about differences in social well-being excepting under empirically uninteresting circumstances' (Dasgupta and Göran Mäler, 2000, pp. 84-86). Dasgupta's and Göran Mäler's result suggests that Pigou's definition of economic welfare in terms of national dividend is too narrow, and calls attention to Adam Smith's definition in terms of a *fund* capable of delivering a *flow* of goods and services.

Smith's conception of 'labour commanded' is a powerful tool for wealth analysis. Its most distinctive feature is that it distances the measurement of wealth from the availability of treasure, and makes the 'command' on labour a general capacity to be realized in a *variety of conditions*. Labour commanded (and the wealth associated with it) can derive from the practice of useful activities or from the availability of useful assets. In general, the labour commanded by any given nation derives from a *portfolio of labour-commanding resources* (some associated with production activity, others associated with the ownership of natural or financial assets).

The labour-commanded view suggests that the wealth of any given nation may be stationary, increase or decrease as result of changes in its portfolio of labour-commanding resources. Three principal cases may be distinguished. In one case, the wealth increase may result from an expansion of productive activities leading to increasing exports and to an increasing current account surplus (export-led wealth increase). Here, the command on labour increases due to competitive advantage and international trade. A second case is that in which the command on labour (thus, available wealth) increases merely as a result of treasure appreciation (increased value of financial assets). In a third case, the command on labour increases as a result of the expansion of the production of goods and services that are not internationally traded. Here, the increased command on labour may be associated with the expansion of social, educational or environmental activities (and is independent of a current account surplus). Finally, we may have an increased command on labour induced by an *upgrading* of the production of goods and services (independently of whether they are internationally traded or not). For example, the labour commanded by a typical service activity at time t may be greater than the labour commanded by that activity at time $t-1$.

In short, any given country has more labour commanded at its disposal if there is an increase in the over-all command on labour associated with its activities or its endowments. A country with a highly developed division of labour is normally wealthier than a country in which division of labour has a narrower scope.

The theory of entitlements is closely associated with the labour commanded view originally formulated by Smith. This theory suggests that the *bundle of entitlements* upon which the average citizen of any given country may lay a claim measures the average welfare in that country. To conclude, there is an important tradition in economic theory according to which the measurement of wealth cannot be detached from the measurement of welfare.[22]

[22] The theory of entitlements gives a clue into the relationship between the wealth of any given country and the extent of the division of labour in that country. This is because, in a country characterized by a developed division of labour, the average citizen may command a larger and more diverse bundle of entitlements relative to the average citizen of a country in which division of labour is less developed. The same is true for international division of labour. Here, the

4. Welfare, Trade and Growth Policy

4.1. A Taxonomy of Welfare Policies: Capacity Promotion vs. Well-being Promotion

The average welfare of the citizen of any given country has a different structure depending on whether we consider *capacity development* or *well-being*. Capacities are associated with productive abilities, and may be promoted by educational policies[23]. Well-being is associated with objective living conditions or the satisfaction of needs and desires: health care system and social insurance are among the appropriate policy instruments. Of course, there may be considerable overlap between actions promoting the development of capacities and actions directly promoting the well-being of individuals.

Capacity promotion and well being promotion may be an end in itself, or they may be instrumental to the achievement of *other goals*. And these goals may be sharply different in the two cases. Capacities are inherently *intentional.* This suggests that, in certain cases, the development of capacities makes individuals (or groups) better able to perform tasks or functions that may be assigned to them. In particular, some of these tasks may be instrumental to the production of traded goods and services. In this way, capacity development can both be an objective in itself and a means to achieve a better performance in the formation of marketable wealth. The direct promotion of well-being has different implications. For well-being is *not* inherently intentional. This means that, differently from capacity promotion, well-being promotion is not directly instrumental to the promotion of competitiveness on international markets.

The distinction between capacity development and well-being development suggests that welfare policies may take two alternative routes. In one case (*capacity promotion*), welfare policies target the productive potential (in a wide sense) of human beings. In the other case (*well-being promotion*), welfare policies target the objective living conditions or the 'feeling potential' of human beings.

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average citizen of a country whose terms of trade allow access to the full range of internationally traded goods and services commands a larger and more varied bundle of entitlements relative to the average citizen of a country whose terms of trade only allow limited access to international markets. Entitlement to an expanded set of goods and services (marketed or not) is associated with increased national wealth. The average citizen of any given country is wealthier both when the terms of trade of her country are improving *and* when the set of 'internal entitlements' in that country are expanding. This suggests that the dynamics of the wealth of nations may be affected by conflicting influences. For example, the wealth (and welfare) of the average citizen of any given country may alternatively increase, decrease or remain constant, if an improvement of the international terms of trade of his country is associated with a contraction of the internal entitlements to which that average citizen has access.

[23] Capacities in our sense are different from Sen's capabilities. See Sen (1985, 2004).

It is possible to design welfare policies in which the emphasis on capacity promotion comes at the expense of well-being. This may be the case if policy promotes certain capabilities out of proportion relative to others, so that the over-all balance is lost. On the other hand, it is possible to design a welfare policy in which well-being is promoted at the expense of capacity development. For example, a welfare policy could promote the alleged well-being of consumers by simply increasing their purchasing power without targeting the structure of consumer expenditure (and thus, presumably, forsaking the goal of deeper changes in consumer capacities).

4.2 The Impact of Welfare Policies upon Trade Performance and Capital Flows

The two welfare policies have different economic consequences. It is generally admitted that capacity promotion (for example, through better educational systems) is likely to increase the productive potential of a given economy, both quantitatively and qualitatively. This may be associated with increased competitiveness and better performance on world markets.

Less well known, but no less important, is that well-being promotion may induce a significant taste improvement of the average consumer, making her able to demand more sophisticated goods as services (especially if well-being promotion induces a change in consumer capacities). Although this situation is not immediately translatable into macroeconomic consequences, a more sophisticated demand structure may induce a significant transformation of the internal market for high value-added goods, and thus indirectly become an important incentive for the development of sophisticated technical abilities.

Carlo Poni and Neil McKendrick have produced historical examples of such a promotion of consumer capacities leading to a striking increase in international competitiveness. Carlo Poni has argued that the commercial and industrial development of the towns of northern and central Italy in the middle ages was initially stimulated by internal demand for sophisticated consumer goods (a feature he associates with the relatively 'horizontal' distribution of purchasing power in the upper social strata of urban population). (Poni, 2001). A similar argument was made by Neil McKendrick in the context of the consumer revolution of 18th century Britain. In this case, according to McKendrick, the expansion of middle social strata made possible the mass consumption of high-quality consumer goods and the development of the corresponding technical skills for their production (Mc Kendrick, 1970; see also McKendrick, Brewer and Plumb, 1982). In both cases (medieval Italy and 18th century Britain) consumers developed sophisticated 'niches of taste', which in turn encouraged the development of technical abilities and ultimately affected in a positive way the international competitiveness of locally produced goods and services.

Through these channels, welfare policy may be an important instrument of trade policy. But, as we have seen, its effects may be hugely different depending on its target and structure. Virtuous or vicious circles may be set in motion, depending on policy design. A welfare policy based upon capacity promotion may induce increased competitiveness. However, this increase may come at the expense of well-being (especially if a policy of unbalanced capacity promotion is pursued). Similarly, a welfare policy exclusively based upon transfers of purchasing power may reduce competitiveness on world markets (especially if that policy is associated with a constant or slowly adjusting structure of consumer expenditure). In both cases, a *vicious circle* is introduced, in which well-being and capacity are conflicting objectives, and may ultimately weaken each other in the long-run. But it is important to point out that welfare policy may also induce a *virtuous circle* of welfare and competitiveness improvements. As our historical examples show, a policy of well-being promotion aimed at the development of consumer capacities (see above) could go hand in hand with a policy of capacity promotion aimed at the development of producer capacities. We may expect that such a policy could lead to an improved export performance of the productive sectors originally stimulated by the expanded internal demand for sophisticated (or new) consumer goods.

In addition to their effects on trade policies, different approaches to the welfare of nations may be associated with different approaches to international finance.

Our argument can be restated by looking at the two sides of a country's balance of payments. On the current account side, capacity-oriented welfare policy is likely to directly encourage the active promotion of technological capabilities, and more generally the active governance of the competitive advantage on international markets. For example, an active educational policy may be part of this approach (although education may also promote capacities that are not necessarily instrumental to the promotion of competitiveness on international markets).

Coming to the financial side, welfare policy is similarly double-hedged with respect to international capital flows. Capacity promotion may require very substantial capital inflows, and thus be associated with a policy of relative openness to international capital markets. On the other hand, substantial public investment may be a condition for the promotion of capacities. In this case, constraints upon capital flows may be likely, if taxation of income and wealth is the principal source of State finance.

Capital flows may also be positively or negatively affected by well-being oriented policies, which are often associated with the expansion of internal demand. In one case, well-being promotion in the absence of development in consumer capacities is likely to induce the growth of imported resource and goods, which may ultimately determine substantial capital outflows and calls for

restriction on international capital flows. By contrast, well-being promotion associated the development of consumer capacities and the acquisition of new competitive advantages on international markets has different consequences. In an early phase, international capital flows are initially less significant, since the expansion of internal demand is associated with the expansion of internal capacities. In a later phase, increased exports of internally produced goods may bring about a significant increase of capital inflows. Both in its early and in its late phase, this scenario excludes significant restrictions upon international capital flows.

To sum up, welfare policies may be an important influence upon the formulation of trade policy and international monetary policy. However, *this influence is not unambiguous*. A capacity-oriented policy is generally associated with freedom of trade in commodity markets, but may also be associated with demands for restrictions on international capital flows if the financing of capacity promotion depends primarily (or exclusively) on taxation. Similarly, a well-being oriented policy may eventually induce restrictions to free trade both in the commodity and capital markets if internal demand expansion takes place independently of any significant development in consumer capacities.

As a final point, it is important to note that, in our evaluation of different types of welfare policies, we have thus far assumed the international monetary system as a given constraint. Consequently, we have tried to assess the positive or negative impact of these policies on the required trade and current account surplus. However, as we argued above, these surpluses may become a less binding constraint, following the current gradual introduction of a multilateral set of monetary arrangements. As we argue below, this weaker current account constraint opens up an entirely new scenario, whereby welfare policies acquire some degree of autonomy.

5. A Trade Scenario and a Welfare Scenario: Alternatives for Europe.

At the beginning of the 21st century, Europe is facing two alternative policy scenarios. In the first scenario (the *trade scenario*), Europe takes the system of international monetary arrangements as given, and determines on that basis its set of welfare policies. In the second scenario (the *welfare scenario*), Europe takes a system of welfare institutions as given, and determines on that basis its trade policy. This rule of decomposition in the analysis of economic policy has interesting implications. In particular, the above decomposition rule entails that the feasibility of welfare and trade policies may depend upon which hierarchy of goals is considered[24]. The trade scenario renders

[24] The rule of decomposition (for the policy domain) stipulates a given objective and moves back from that objective to the set of policy options compatible with it. It is an application of Lowe's instrumental analysis since, rather than arguing 'from behavioural premises to terminal states' (Lowe, 1976, p.12), it searches " backward" for the determinants

welfare policies feasible or unfeasible depending on whether they are compatible with the stipulated rules of trade. The welfare scenario makes trade policies feasible or unfeasible depending on whether they are compatible with the stipulated welfare objectives.

It is important to emphasize that, within each scenario, a *range of different policies* is available. In the trade scenario (which is close to the current position of Europe in the world economy), welfare policies may be an important instrument for the achievement of the stipulated trade objective (a current account surplus). However, the trade objective may require the implementation of a specific bundle of welfare policies to the exclusion of others. For example, current account surpluses may be compatible with the implementation of welfare policies aimed at well-being promotion through the development of consumer capacities, or to the implementation of policies directly aimed at the development of technical abilities in export-led sectors. On the other hand, current account surpluses may be incompatible with welfare policies aimed at capacity development (particularly when the financing of the corresponding investment leads to the relative 'closure' of international capital markets). They may also be incompatible with welfare policies aimed at well-being promotion through the expansion of the internal demand for traditional goods and services. In this perspective, some current policy proposals pursued at the European level suggest an export-led (or mercantilist) point of view. The idea that there is a trade off between the welfare of an economic area and its competitiveness is a mercantilist proposition that was already criticized long ago by Daniel Defoe[25]. As we have seen, the contraction of welfare expenditure and social rights as a necessary condition for international competitiveness is *but one option* within the trade scenario.

Similarly, a range of different trade policies is available if the welfare scenario is considered. In this

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of given states' (Lowe, *ibidem*). Lowe also emphasized the essentially heuristic character of instrumental analysis (Lowe, 1976, pp. 12-13; see also Scazzieri, 1998). A similar approach is followed by John Hicks in his discussion of optimum theory: '[t]he form of organization by which the optimum is to be reached is not prescribed; the question whether it can be reached by a competitive system is left open. The general character of the path which will satisfy optimum conditions is the sole question that is at issue' (Hicks, 1965, p. 204).

[25] Daniel Defoe, in his *Plan of the English Commerce* (1728), strongly criticized the common mercantilist proposal of low wages as a means to enhance international competitiveness, and denied that 'a country might become rich through the poverty of its people' (Huckster, 1994, p.171; 1st end 1931). In particular, Defoe countered the low-wage proposition by arguing that ' [if] […] these Gentlemen who are forcing the Consumption of our Manufacture in England (or in any of those countries in Europe where they work cheapest) by their mere Cheapness, are content to reduce the wages of the People who make them, to the rate of those in China or India, there is no doubt they might increase the Consumption and sell of f the quantity: but what would be the Advantage? They would sell their Goods and ruin their People; the Benefit of which in the Gross, I confess I do not understand' (Defoe, 1728, as quoted in Huckster, 1994, 1994, vol. II, p. 171). An echo of Defoe's argument is to be found in Smith's statement that '[n] o society can surely be flourishing and happy, of which the far greater part of the members are poor and miserable' (Smith, 1776, *WN*, I.viii.36).

case, we may expect different policies depending upon whether capacity promotion or well-being promotion is being pursued. Capacity promotion is compatible with unlimited free trade if capacity investment is financed through international capital (rather than with internal capital or taxation). Well-being promotion is compatible with unlimited free trade if the expansion of internal demand is associated with the development of consumer capacities. In general, however, the welfare scenario makes free trade to be feasible *along a continuum of possibilities*. For example, with a capacity-oriented policy, free trade in commodity markets may be more likely than free trade in capital markets, and free trade in capital markets may presuppose a specific structure of investment finance for capacity development (see above). On the other hand, with a well-being oriented policy, import-substitution may be favoured relative to free trade in an initial phase (when consumer capacities have not yet developed to a sufficient degree). In a later phase, import-substitution may be dropped and the emphasis of trade policy may shift towards free trade (presumably, first in the markets where a competitive advantage has been acquired, later in the markets for other goods and services).

6. Concluding remarks.

This paper has explored the relationship between economic growth and the welfare state by raising two questions: firstly, can growth differentials between economic systems be explained by differences in the dimensions and characters of their welfare systems? Secondly, is economic growth compatible with one single social model, or with a variety of welfare systems? The underlying, basic question is easy to detect: should Europe give up its welfare oriented social system, or rediscover and implement a model more actively centred on the welfare of its citizens?

The proposed approach has focused on the institutional international scenario. In order to assess the constraints on, and the opportunities for growth in different countries, we have focused on the working of the international monetary system, and on its recent evolution following the introduction of the Euro.

We have argued that the international monetary system imposes a different "discipline/flexibility mix" on each country (or group of countries), and that the asymmetries thus generated may go a long way towards explaining growth differentials between economies. The current debate on welfare systems, while duly considering the global dimension, may have underrated the influence of this *specific* international factor.

International constraints are a critical influence on growth, welfare and trade policies in Europe. We have argued that, even taking these constraints fully into account, two broad sets of alternative are open.

Firstly, the trade scenario may or may not require a diminished role for welfare institutions,

depending on the choice of a welfare threshold, and on the prefereed mix of well-being and capacity oriented welfare policies. Europe has a fine choice between alternative policy options within this scenario, and the mercantilist model should not be taken for granted.

Secondly, we argue that Europe may also envisage a more fundamental choice between alternative scenarios. Gradually, the new money, if successfully established in international markets, may enable Europe to overcome the mercantilist identification between "treasure" and wealth, and to avoid the need for *systematic* current account surpluses. Welfare policies, if properly devised, may be a useful instrument in this evolution from a *trade scenario* to a *welfare scenario*.

Actual choices will reflect equilibria determined by existing institutions, beliefs and the contrasting influence of interest groups.

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